The field of healthcare finance is shaped by the financial environment in which it is practiced. This chapter provides information on business organizations, goals, taxes, third-party payers, and reimbursement methods.
There are four major categories of business organization (legal forms of businesses).

- Proprietorship (sole proprietorship)
- Partnership
- Corporation
- Hybrid forms

How much does the organizational form influence the practice of healthcare finance?
Proprietorships and Partnerships

- **Advantages**
  - Ease of formation
  - Subject to few regulations
  - No corporate income taxes

- **Disadvantages**
  - Limited life
  - Difficult to transfer ownership
  - Unlimited liability
  - Difficult to raise capital
Corporation

- **Advantages**
  - Unlimited life
  - Easy transfer of ownership
  - Limited liability
  - Ease of raising capital

- **Disadvantages**
  - Cost of formation and reporting
  - Double (or triple) taxation for investor-owned corporations
Hybrid Forms of Organization

- **Limited partnership (LP)**
  - *General partners* have control
  - *Limited partners* are liable only for their initial contribution
  - Not commonly used by healthcare providers

- **Limited liability partnership (LLP)**
  - Partners share general business liability
  - But, partners are liable only for *their own* malpractice actions
Hybrid Forms of Organization (Cont.)

- **Limited liability company (LLC)**
  - Members are taxed like partners
  - Liability like stockholders

- **Professional corporation (PC) or professional association (PA)**
  - Owners have benefits of incorporation
  - However, still liable for malpractice
  - Often used by individual clinicians
In most industries, the only form of ownership is the investor-owned (for-profit) business.

However, in the health services industry, a significant proportion of businesses, particularly hospitals, are organized as not-for-profit corporations.

How much does ownership influence the practice of healthcare finance?
Investors become owners by purchasing shares of **common stock**.

- **Primary market transactions**
  - Initial public offerings (IPOs)
  - New common stock sales

- **Secondary market transactions**
  - On exchanges
  - In the over-the-counter market

**Stockholders have:**

- Right of control
- Claim on residual earnings and residual liquidation proceeds
If a business meets a stringent set of requirements, it can qualify as a not-for-profit (nonprofit) corporation. Such firms also are called tax-exempt or 501(c)(3) or (c)(4) corporations.

These corporations:
- Generally have no shareholders, and hence do not have a single clientele to which managers are responsible.
- Receive various tax exemptions.
- Must file Form 990.
Discussion Item

Not-for-profit businesses generally are exempt from local property taxes and state and federal sales and income taxes. Overall, this benefit is worth several billion dollars annually to NFP hospitals.

Do NFP hospitals provide community care equal to the value of their tax exemptions?

Should these hospitals be required to provide indigent (charity) services equal to the tax benefits received?
The primary goal of investor-owned corporations is shareholder wealth (stock price) maximization.

- Do investor-owned businesses have any responsibilities to society at large?
- Is stock price maximization good or bad for society?
- Should such firms behave ethically?

What is the primary goal of proprietorships and partnerships?
The primary goal of not-for-profit corporations is generally given by a mission statement, often in terms of service to the community.

All businesses have stakeholders.
- Stakeholders have an interest (usually financial) in the business.
- Not-for-profit managers must satisfy all stakeholders.
- For-profit managers are primarily concerned with satisfying stockholders.
Financial Goals

- The primary financial goal of investor-owned corporations stems from their organizational goal: shareholder wealth (stock price) maximization.

- The primary financial goal of not-for-profit corporations is to ensure the financial viability of the organization.

Does the difference in financial goals lead to appreciably different behavior?
Some understanding of tax laws is necessary because taxes influence:
- Financing decisions
- The operating cash flows available to an investor-owned business
- The ability to raise contribution capital

There are several types of taxes:
- Federal versus state versus local
- Personal versus corporate
- Ordinary income versus capital gains
Individuals pay federal (and perhaps state) taxes on salaries, interest, and other income at rates that can approach 50%. (Dividends and capital gains are taxed at lower rates.)

Consider a person paying 40% in taxes that receives $100 in interest:

\[
AT = BT \times (1 - T)
\]
\[
= $100 \times (1 - 0.40)
\]
\[
= $100 \times 0.60 = $60.
\]
Investor-owned corporations pay federal and state taxes on corporate income at rates that can exceed 40%.

Not-for-profit corporations, for the most part, are not subject to taxation.

Not-for-profit corporations have two additional tax benefits:
- Can issue tax-exempt (municipal) bonds
- Can receive tax-exempt contributions
Assume FP Healthcare must offer a 10% interest rate on its new bonds.

Jane Green, an individual investor with a 28% tax rate, buys one $1,000 bond. What is the effective (after-tax) annual interest?

\[
\text{AT$} = (0.10 \times \$1,000) \times (1 - 0.28) \\
= \$100 \times 0.72 = \$72.
\]

\[
\text{AT%} = 10\% \times (1 - 0.28) = 10\% \times 0.72 \\
= 7.2\%.
\]
Assume NFP Healthcare can issue similar-risk municipal bonds with an 8% interest rate. Should Jane buy the NFP bond rather than the FP bond?

At what rate on the FP bond would Jane be indifferent between the two bonds?

$AT\% = BT\% \times (1 - T)$

$8\% = BT\% \times (1 - 0.28) = BT\% \times 0.72$

$BT\% = 8\% \div 0.72 = 11.1\%.$
For the most part, provider revenues come from third-party payers rather than from patients.

- Private insurers
  - Blue Cross/Blue Shield
  - Commercial insurers
  - Self-insurers

- Public insurers
  - Medicare
  - Medicaid
Managed care plans strive to combine both the provision of healthcare services and the insurance function in a single organization.

There are many types of plans:
- Health maintenance organizations (HMOs)
- Preferred provider organizations (PPOs)
- Point of service (POS) plans

In general, the purpose of managed care plans is to control costs. How?
Regardless of the payer, there are only a limited number of payment methods.

Methods fall into two broad categories:

- **Fee-for-service (FFS)**, where payment is tied to the *amount of services provided*.
  - Charge based
  - Cost based
  - Prospective payment

- **Capitation**, where payment is tied to the *size of the covered population* (number of enrollees).
Payer pays billed (gross) charges for services rendered.

Historically, all third-party payers reimbursed providers on the basis of billed charges.

Some payers still use billed charges as the payment method, but often negotiate a discount from gross charges ranging from 20-50 percent (or more).

What should the uninsured pay for healthcare services?
FFS: Cost-Based Reimbursement

- Payer pays all *allowable costs* incurred in providing services.

- Typically, *periodic interim payments* are made, with a final reconciliation at the end of each year.

- Medicare used this method for hospitals in its early years (1966-1983).
Prospective payment methods have a fixed payment determined beforehand that is, at least in theory, unrelated to either costs or charges.

Prospective payment may be on a:
- Per procedure basis
- Per diagnosis (DRG) basis
- Per diem (per day) basis
- Global pricing basis
Capitation is entirely different from FFS reimbursement.

- Payment is not tied to utilization, but rather to the number of covered lives.
- Payment to providers usually is made on a per member per month (PMPM) basis.
- Used primarily by managed care plans.

The impact of capitation will be examined in later chapters.
Assume that you are the CEO of a hospital. What are the incentives to the organization under the following reimbursement methods?

- Charge-based reimbursement
- Cost-based reimbursement
- Per diagnosis (DRG) reimbursement
- Per diem reimbursement
- Global reimbursement
- Capitation
Coding is the first step in the reimbursement process.

Coding is performed by administrative personnel (coders) on the basis of clinicians’ notes.

Two different types of codes:
- International classification of diseases (ICD) codes
- Current procedural terminology (CPT) codes
ICD Codes

ICD codes are used to specify diseases, symptoms, or injuries.

The codes consist of 3, 4, or 5 digits. The greater the number, the more detailed the information. For example,
- 410 is heart attack
- 410.0 specifies the anterior wall

ICD codes are used by hospitals to specify inpatient diagnoses. Will update from ICD-9 to ICD-10 in 2013.
CPT Codes

- CPT codes are used to specify medical procedures (treatments).

- The codes are 5 digits. For example:
  - 99211 is a simple (short) office visit
  - 99215 is a complex (long) office visit

- CPT codes are used by clinicians to specify procedures performed on patients.

- An enhanced version used by Medicare and Medicaid is called the Healthcare Common Procedure Coding System (HCPCS), pronounced “hick picks.”
Healthcare Reform

- Healthcare reform is a generic term used to describe the 2010 Patient Protection and Affordable Care Act (ACA).

- It was designed to:
  - Decrease the number of uninsured
  - Slow the growth of government health insurance program costs

- Because its implementation will not be completed until 2018, there is a great deal of uncertainty regarding its impact.
Although the ultimate fate of healthcare reform is unknown, here are some concepts that appear to have lasting power:

- Value-based purchasing
- Accountable care organizations (ACOs)
- Medical home (patient-centered medical home) model

Only time will tell!
This concludes our discussion of *Chapter 2* (The Financial Environment).

Although not all concepts were discussed in class, you are responsible for all of the material in the text.

Do you have any questions?